DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ROBERT H. SCHORMAN, JR.
ATTORNEY
CC:LM:CTM:LA:2

FROM: William P. O'Shea
Acting Associate Chief Counsel
CC:PSI:FO

SUBJECT: Leveraged Partnership

This Chief Counsel Advice responds to your memorandum dated May 9, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Assets =

Business =

X =

Y =

Z =

A =

B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=
M	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=

Time 1	=
Month 1	=
Year 1	=
Note 1	=
Note 2	=
Term 1	=
Term 2	=
Term 3	=
Term 4	=
State 1	=
$A	=
$B	=
$C	=
$D	=
$E	=
$F	=
$G	=
$H	=
$I	=
$J	=
$K	=
$L	=

$M	=
$N	=
$O	=
$P	=
$Q	=
$R	=
$S	=
$T	=
$U	=
$V	=
$W	=
$X	=
$Y	=
$Z	=
$AA	=
$BB	=
$CC	=
A%	=
B%	=
C%	=
D%	=
E%	=

F% =

G% =

H% =

ISSUES

(1) Whether the guaranty by Y of the indebtedness of Z may be disregarded pursuant to section 1.752-2(j) of the Income Tax Regulations.

(2) Whether the contribution of Taxpayer's Assets, and the ensuing distribution, should be recharacterized as a disguised sale by Taxpayer to Z pursuant to section 707(a)(2)(B) and the regulations thereunder.[1]

(3) Whether transaction can be recast as a sale between Taxpayer and D pursuant to section 1.701-2 of the Income Tax Regulations.

(4) Whether the form of the transaction should be disregarded and recharacterized as a sale between Taxpayer and D.

(5) Whether Z is a valid partnership for federal income tax purposes.

CONCLUSIONS

(1) Yes, the guaranty by Y of the indebtedness of Z may be disregarded pursuant to section 1.752-2(j) of the Income Tax Regulations.

(2) Yes, provided the guaranty by Y is disregarded, the related contribution and distribution will be treated as a disguised sale under section 707(a)(2)(B).

(3) Yes, it appears that the transaction is inconsistent with the intent of subchapter K and was entered into with a principal purpose of tax avoidance. Accordingly, the transaction can be recast under section 1.701-2.

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[1] Y is a wholly-owned affiliate of Taxpayer. This transaction was structured with both Taxpayer and Y contributing assets to Z in exchange for partnership interests, but with Taxpayer subsequently contributing its interest in Z to Y. Y is the putative partner of Z for most of the transaction, but the consequences of Y's transactions are recognized by Taxpayer, as a consolidated group. Accordingly, this memorandum will generally refer to Taxpayer as the putative partner, but will specifically identify Y where it is significant for the analysis.

(4) Yes, under the substance over form doctrine, it is appropriate to disregard the form of this transaction (contribution and distribution) and treat it in accordance with the underlying substance (sale).

(5) It does not appear that the Taxpayer had the necessary intent to become a partner. Accordingly, Z should not be treated as a partnership for federal tax purposes, and Taxpayer should be treated as selling Assets rather than making a contribution.

FACTS

Overview

On Date 1, Taxpayer announced that it planned to either spin-off or sell all of its Business operations. After an evaluation of bids from several companies, on Date 2, Taxpayer announced an agreement with X to dispose of its United States Assets. To facilitate this, Taxpayer sold some of its Assets to X and contributed other Assets to a joint venture with X.

Later, in Month 1 of Year 1, A, a Taxpayer subsidiary, sold its membership interests in B, a subsidiary LLC of A, and A% interest in C to the X subsidiary, D. Among the assets transferred to D was stock in E. B owned B% and C owned C% of the stock of E. In return for a D% common equity interest in a new limited liability company, Z, D contributed these E interests as well as its interests in F and cash.

Taxpayer transferred certain Assets to G, a single member LLC. Taxpayer then contributed its membership interests in G to Y, a wholly-owned subsidiary, in a section 351 transaction. Taxpayer received partnership interests in Z in exchange from the contribution of Taxpayer's interests in H, a single member LLC. Following this, Taxpayer contributed to Y its membership interests in Z. Y then contributed its membership interests in G to Z. Thus, Y ended up with a E% common equity interest and a E% preferred interest in Z. The reported fair market value of the property transferred to Z from Y was $A. Finally, Z elected to be treated as a partnership for federal tax purposes.

Z borrowed $B from a syndicate of banks. Z received the funds on Date 3 and immediately made a special distribution of $C to Y. On Date 4, Y then distributed $C as a dividend to Taxpayer. Y guaranteed Z's $B liability, and increased its basis in its interest in Z pursuant to sections 752(a) and 722.

Z also distributed $D of cash to Y contributed by D. Y treated $E of this distribution as a reimbursement of capital expenditures incurred in the two-year period preceding the contribution with respect to certain Assets contributed by Y. The remaining $F of the cash distribution was reported as a taxable sale of certain

Assets by Y to Z under the disguised sale regulations. Z assumed $G of qualified liability pursuant to section 1.707-5(a)(5)(i) of the Income Tax Regulations. Taxpayer reported an additional $H as consideration to Y.[2] The total sales proceeds were reported as $I, less a basis of $J. This resulted in a taxable gain of $K. Finally, the sum of $B plus $D, plus $G equals $L, which is approximately the fair market value of Assets transferred to Z.

The Loan

On Date 3, Z entered into a $B Term Loan Credit Agreement ("Agreement") with I, as administrative agent, J, as the syndication agent, and K, as the documentation agent.

The Agreement provides for Note 1, evidencing Z's obligation to each lender in the syndicate. The principal amount of each Note 1 is due and payable on Date 5. Thus, the initial term of the loan is Term 1.

The Agreement also provides that Z will only use the loan monies to finance a portion of the special distribution to Y of $C. In addition, the Agreement acknowledges that the special distribution will be further distributed to Taxpayer on or about the date of the Agreement.

Under the Agreement, I received a variety of security interests in Z's property. Z pledged Note 2 of X, dated Date 3, in the principal amount of $M. Note 2 is pledged as security for its subsidiary interests in A, B, C, F, G, and H. In addition, Note 2 is also pledged as security funds to be deposited into a special escrow account kept by I. Lastly, B and H were required to guarantee and become sureties for the loan to Z.

The Subsidiaries' Guaranty

B and H were required to execute a Continuing Guaranty and Suretyship Agreement ("Guaranty Agreement") regarding Z's loan. The Guaranty Agreement contains language making it an absolute and unconditional guaranty of payment. Thus, the lenders have the ability to require payment from the guarantors (B and H) without first trying to collect from Z, the primary debtor, if Z fails to make a payment or otherwise defaults under the Agreement. Furthermore, the Guaranty Agreement is also a continuing guaranty. Thus, it is not limited to an isolated transaction, but rather, it contemplates a series of transactions often for an indefinite time period.

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[2]Based on multiplication of the amount of qualified liability by Y's net equity percentage.

The guaranty is unsecured and sets forth many waivers of possible defenses of the guarantors (B and H). Thus, few rights are given to B and H, but many of the banks' rights are preserved.

The Y Guaranty

Y's guaranty is memorialized in a document entitled "Master Guaranty of Collection" ("Master Guaranty"), dated Date 3. The Master Guaranty is a guaranty of collection as to the principal only on the indebtedness of Z. Specifically, it does not extend to any liability for interest, premiums, or any other amounts payable in connection therewith. Thus, it only covers the original aggregate principal amount of $B, subject to reduction due to payments of principal by Z or another guarantor. Finally, in addition to a maximum of $B in liability to Y under the Master Guaranty, the guaranty is unsecured.

By the terms of the Master Guaranty, Y has no liability under the guaranty until the banks have exhausted their remedies against Z. Furthermore, the Master Guaranty is continuing during its period of effectiveness – Date 3 through the earlier of: (a) the time at which the guaranty amount ($B) is reduced to zero, (b) Time 1 on Date 6, or (c) the time Y ceases to be a member of Z. The Master Guaranty was expressly designed to have an effective period of Term 2. Yet, Note 1 has initial terms of Term 1. Thus, it appears that refinancing of the loan was contemplated by the parties as an option after Term 1.

The Purchase and Sale Agreement

On Date 2, Taxpayer, X, A, and D were parties to a Purchase and Sale Agreement that provided for the sale by A of its membership interests in B, M, and C to D for $N. The Purchase and Sale Agreement also provided for the adjustment of the purchase price based on financial information regarding Taxpayer to be provided by the seller within ninety (90) days of Date 3 (the closing date). A Memorandum of Agreement, dated Date 7, between Taxpayer and X, evidences that the buyer (D) paid the seller an additional $O. Thus, the total consideration paid under the Purchase and Sale Agreement was $P.

Taxpayer reported a taxable loss of $Q. This is based on the sale proceeds of $R, less selling expenses of $S and a taxable basis of $T on the sale of these membership interests.

The Contribution Agreement

On Date 8, D, X, Y, and Z entered into a Contribution Agreement. The Contribution Agreement provided for: (a) the contribution to Z by Taxpayer of its membership interests in H, (b) Y's contribution to Z of its membership interests in G, and (c) D's contribution of its membership interests in B, C, F, and A and $U in cash to Z.

The Contribution Agreement obligates Z and the other parties to the Contribution Agreement to cause Z to make a special distribution of $C to Y. Thus, Y has a contractual right under the Contribution Agreement to the special distribution. Furthermore, the Contribution Agreement provides for an adjustment to the special distribution based on the financial results of Taxpayer. Thus, the special distribution is linked to the value of Assets, making it appear to be a payment for Assets.

The Memorandum of Agreement, dated Date 7, between X and Taxpayer evidences that D agreed to pay $V to Z. This amount, plus the $U contributed by D to Z, was reported as a cash distribution of $D from Z to Y.

The Limited Liability Company Agreement of Z

On Date 3, D and Y entered into a limited liability company agreement ("LLC Agreement") concerning Z. Z was formed on Date 9 by D as a limited liability company under State 1 law. The assets contributed by Y and Taxpayer had a total value of $W. Assets contributed by D were valued at $X and, in addition, D also contributed $U in cash. Thus, Taxpayer and Y's contributions represent F% of all the assets and cash contributed to Z. However, Y's common membership interest is only E%.

The LLC Agreement provides that D is the managing member. In its capacity as managing member, D has the authority and power to manage and control the "business, affairs, and property" of Z. However, Z cannot, without prior written consent of all of the member, make distributions of cash or property to a member, make a loan to a member or invest in a member or a member's affiliate, incur indebtedness, sell, lease, abandon or otherwise dispose of company assets except in the normal course of business or consolidate with or merge into another person, if a minimal credit rating is not maintained by Z. Thus, Y essentially maintains the right to veto any actions by Z that might adversely affect Z's credit rating if the minimum required credit rating is not maintained by Z.

Y also maintains contractual rights given to it under the LLC Agreement against the dilution of its E% common interest. Thus, if another party makes an additional capital contribution to Z, Y has the right to contribute in either cash or property an equal or lesser amount as is necessary to maintain its common percentage interest in Z.

In addition, the LLC Agreement contains both a put and a call option. The put is structured as follows: after Term 3 from Date 3, Y has the right to require D to purchase all or part of Y's interest upon providing at least Term 4 advance written notice. The purchase price of the put is to be determined by the parties. If the members cannot agree on a price, a formula is provided for determining the purchase price. Finally, if the put option is exercised, no damages are payable to Y under the Tax Sharing Agreement (discussed below).

The parties also agreed that at any time after Date 3, D has the ability to issue a written notice (at least Term 4 in advance) of its intent to purchase or cause another to purchase all, but not less than all, of Y's membership interests at a price equal to the sum of the Preferred Capital Amount[3] and any accrued and unpaid Preferred return thereon and the Net Equity of the Y Common Percentage Interest[4] determined as of the last day of the fiscal quarter immediately preceding the fiscal quarter in with the written notice was given, together with damages determined as set forth in the Tax Sharing Agreement (discussed below). If the call rights are exercised after Date 10, no damages or other amounts are due under the Tax Sharing Agreement.

The Tax Sharing Agreement

The parties to the Tax Sharing Agreement ("Tax Agreement") are D, X, Y, and Z. The Tax Agreement was dated Date 3. Under the terms of the Tax Agreement, X and D agreed to indemnify Y for the loss of the anticipated tax deferral on the special distribution that resulted from Y's guaranty if caused by X or D, for Term 2 after Date 3. The Tax Agreement additionally provides that if any of the following takes place, X must pay compensation to Taxpayer: (a) there is a final determination of a federal tax liability of Taxpayer or an affiliate, arising from the contribution of X's assets, or the distribution to Y and D; or (b) an X affiliate receives an actual cash tax benefit.

LAW AND ANALYSIS

Issue One: *Y's Guaranty of Z's $B Liability*

[3]The Preferred Capital Amount is defined in the LLC Agreement as that portion of Y's original capital contribution equal to $Y, for which capital Y is entitled to a preferential distribution (the preferred interest). The Preferred Capital Amount is to be reduced by any payments in excess of accrued Preferred Return. The Preferred Return is an amount equal to G% per annum, compounded annually, based on the Preferred Capital Amount balance.

[4]The Common Percentage Interest means initially D% for D and E% for Y, or such other percentage determined by dividing the positive balance in the member's capital account, less any preferred amount therein, by the aggregate of the positive capital account balances of all member's capital accounts.

Taxpayer claims that Y's guarantee of the loan creates a risk of loss for Y so that the liability will be allocated to Y under section 752. It is Taxpayer's position that the increased basis associated with this liability under sections 752(a) and 722 allowed Y to receive the special distribution without any gain recognition under section 731.

Section 1.752-2(b)(6) presumes that partners and related persons who have obligations to make payments will actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Section 1.752-2(j)(1) provides that the Service may disregard an obligation of a partner or related person if the facts and circumstances indicate that a principal purpose of the arrangement was to create the appearance of a partner or related person bearing the economic risk of loss, when the substance of the arrangement is otherwise. Section 1.752-2(j)(3) further provides for the disregard of an obligation to make payment if the facts and circumstances evidence a plan to circumvent or avoid the obligation. Section 1.752-2(j)(4) contains an example which illustrates this rule by providing that the guarantee of an undercapitalized subsidiary of a consolidated group should be disregarded.

In the present case, the purported value of Y's assets may have been as low as $Z at the time of the loan (based on a valuation performed by L). Assuming this to be true, Y appears to be severely undercapitalized with respect to the loan guaranty. Y's guarantee would normally establish a risk of loss under section 1.752-2(b)(6), however, Y's relative lack of capital, the restrictive prerequisites for Y's performance under the guarantee, and Z's pledge of Note 2 from X all suggest a plan to avoid any performance obligation from Y on the guarantee.[5] Accordingly, we believe that Y's guaranty should be disregarded.

When Y's guarantee is disregarded, the liability is treated as a nonrecourse liability under section 752. Section 1.752-3(a) provides for a three-tier allocation of nonrecourse liabilities. First, liabilities are allocated in accordance with the partners' shares of the partnership minimum gain. Second, liabilities are allocated in accordance with the gain that partners would recognize under section 704(c) if the property subject to the liabilities were disposed of for no consideration other than the relief of the liability. Third, excess nonrecourse liabilities are allocated in accordance with the partner's share of partnership profits (as determined by taking into account all facts and circumstances). Alternatively, the partnership agreement

[5]Section 1.752-2(h)(4) prevents the pledge of X's note from being treated as creating a risk of loss for D (a related party to X). That section does not, however, prevent the pledge from being considered in evaluating whether Y's guarantee created a real risk of loss for Y, or merely created the appearance of a risk of loss.

may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under section 704(b) regulations). As a third alternative, the excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions to those nonrecourse liabilities will be allocated.

In the present case, we anticipate that Taxpayer will claim that even if the liability were nonrecourse, sufficient amounts of the liability would be allocated to Y under section 1.752-3(a) so that the distribution would not have resulted in gain under section 731. We will provide additional assistance evaluating the merits of such a claim when and if it is advanced.

Issue Two: *Section 707: Disguised Sale Analysis*

The issue presented here centers on the question of whether the Service can properly characterize Taxpayer and Y's respective contributions on Date 8, followed by the special distribution of $C to Y on Date 3, by Z, as a disguised sale under section 707(a)(2)(B). The purpose of the disguised sale provision is to prevent parties from characterizing a sale or exchange of property as a contribution to a partnership followed by (or preceded by) a distribution from the partnership with the object of deferral or avoidance of tax. H.R. Rep. No. 98-861, at 861 (1984), reprinted in 1984-3 C.B. Vol. 2 at 115.

Under section 707(a)(2)(B), when a partner transfers money or other property directly or indirectly to a partnership where there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner) and if these transfers, when viewed together, are properly characterized as a sale or exchange of property, such transfers will be treated either as a transaction between a partnership and a non-partner, or as a transaction between two or more partners acting as outsiders. Section 1.707-3(c) provides that if within a two-year period, a partner transfers property to a partnership and the partnership transfers money (or other consideration) to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish otherwise.

In the present case, Taxpayer (and Y) contributed approximately $C worth of property to the partnership. The partnership then incurred a liability of $B and distributed the proceeds (plus an additional $U) to Taxpayer (through Y).

It is important to note that Taxpayer reported the distribution that was not debt financed as consideration in a disguised sale. Thus, on the return the taxpayer has conceded the application of section 707(a)(2)(B); the issue presently in contention is whether the $B debt-financed distribution should be treated as consideration as well.

Section 1.707-5(b)(1) provides that (for purposes of section 1.707-3(c)), if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under section 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

Taxpayer argues that Y's guarantee causes Y to be allocated the entire $B share of the liability under the section 1.707-5(a)(2)(i) rules for recourse liabilities. If this were the case, then the distribution would not exceed Y's allocable share of the liability and no part of the distribution would be treated as consideration under section 1.707-5(b)(1). However, as has been discussed, the guarantee by Y should be disregarded under section 1.752-2(j). Accordingly, Y's allocable share of the *nonrecourse* liability will be determined under section1.707-5(a)(2)(ii), which requires partners to determine their allocable share of nonrecourse liabilities in accordance with their method of allocating excess nonrecourse deductions under section 1.752-3(a)(3).

The general default rule of 1.752-3(a)(3) is that a partner's share of excess nonrecourse liabilities is determined in accordance with the partner's interest in partnership profits (determined under all facts and circumstances). Alternatively, the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. In the present case, the partnership agreement provides that H% of the excess nonrecourse liabilities will be allocated to Y. However, this allocation is not consistent with any significant partnership allocation of profits or losses. Accordingly, it seems apparent that attempted allocation is not consistent with the regulations and should be disregarded, leaving Y's share of the nonrecourse liabilities to be determined in accordance with its interest in partnership profits, or E%. Thus, for purposes of section 1.707-5(a)(2)(ii), Y's allocable share of the partnership liability is E% ($BB), and $CC of the $B debt financed distribution will be treated as consideration in a disguised sale.

Issue Three: *Application of the Anti-Abuse Regulations*

Under the partnership anti-abuse regulation, the Commissioner can recast part, or all, of a transaction where a partnership is used or availed with a principal purpose of reducing the partners federal tax liability in a manner that is inconsistent with the intent of subchapter K. Section 1.701-2(b). Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. Implicit in this intent are three requirements: 1) the partnership must be bona fide and used for a substantial business purposes; 2) the transaction must be respected under a substance over form analysis; and 3) the resulting tax consequences must clearly reflect income (or else the distortion must be clearly contemplated by the applicable provision). Section 1.701-2(a). Whether there is a principal purpose of reducing the partners' federal tax liability is determined under all facts and circumstances. Section 1.701-2(c).

In the present case, Taxpayer has monetized its equity in the approximately $C worth of Assets while transferring the benefits and burdens of ownership of those Assets to D (and the X group). As Z pays off the liability, Taxpayer should realize gain under section 731 due to the section 752(b) deemed distributions to Y, however, that is future gain for a benefit that Taxpayer has currently realized. Accordingly, we do not believe that this transaction can be respected under either a substance over form analysis or a clear reflection of income standard. This transaction is therefore inconsistent with the intent of subchapter K.

Furthermore, we are comfortable that this transaction was entered into with a principal purpose of reducing the partners' federal tax liability. We believe Taxpayer's direct sale of its high basis/high value assets to X is a strong indicator that a principal purpose of contributing its low basis/high value assets to Z was the reduction of Taxpayer's federal tax liability. Accordingly, because the transaction was inconsistent with the intent of subchapter K and was entered into with a principal purpose of reducing the Taxpayer's federal tax liability, we believe it is appropriate to apply the section1.701-2 anti-abuse rule.

Issue Four: *Substance over Form*

Under the doctrine of substance over form, the courts may look through the form of a transaction to determine its substance in light of economic realities. As explained by the Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978) (citations omitted):

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents

> are not rigidly binding. Nor is the parties' desire to achieve a particular tax result necessarily relevant.

See also, e.g., Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) ("to permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress"); Gregory v. Helvering, 293 U.S. 465, 469 (1935) (refusing to give effect to transactions that complied with formal requirements for nontaxable corporate reorganization; "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended").

Subchapter K was adopted in part to increase flexibility among partners in allocating partnership tax burdens. See generally, Foxman v. Commissioner, 41 T.C. 535, 550-51 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965). This flexibility, however, is limited by the overarching principle that the substance of the transaction is controlling for tax purposes. Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 200 F.3d 1268 (10th Cir. 1999), aff'g in part and appeal dismissed in part, T.C. Memo. 1996-283. Thus, there is ample precedent applying the substance over form doctrine to partnership transactions. See, e.g., Coven v. Commissioner, 66 T.C. 295, 305 (1976), acq. 1976-2 C.B. 1; Miller v. U.S., 181 Ct. Cl. 331, 337-341 (1967) (both involving a substance over form analysis to determine whether a partner has, in substance, sold a partnership interest or received a liquidating distribution).

Cases involving the issue of substance over form are inherently factual, and the reluctance of some courts to look beyond the form of the transaction prompted Congress to add section 707(a)(2)(B). The circumstances that motivated Congress to act should not be interpreted as a deficiency with the doctrine. There is precedent for the application of the doctrine to transactions that were structured as contributions and distributions, but were more appropriately treated as sales. See, Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793, 813-14 (1988); Jacobson v. Commissioner, 96 T.C. 577, 587-88 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992). We believe that the facts that you have presented establish that Taxpayer has effectively parted with the benefits and burdens of Assets while receiving cash equivalent to the value of Assets. Accordingly, Taxpayer should be taxed in accordance with the substance of this transaction (a sale) and not its form (a contribution and distribution).

Issue Five: *Shamming the Partnership*

Another theory available to the Service is the issue of the existence of a valid partnership in the form of Z for federal tax purposes. It is plausible to argue that Z is not a partnership that should be recognized for federal tax purposes. If Z is not a partnership for federal tax purposes, then Taxpayer is participating in this transaction as something other than a partner and will not be able to rely on the partnership provisions for nonrecognition treatment.

The issue of whether or not a partnership was formed is primarily a question of intent. In Commissioner v. Tower, 327 U.S. 280, 286-287 (1946), the Supreme Court stated:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' We see no reason why this general rule should not apply in tax cases where the government challenges the existence of a partnership for tax purposes. [Citations and footnote omitted].

As the Tower case makes clear, the alleged partners' intent must be determined from an examination of the facts. The Supreme Court later elaborated on and explained its decision in Tower in Commissioner v. Culbertson, 337 U.S. 733, 742 (1949):

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, considering all the facts--the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent–-the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. [Footnote omitted].

In the instant case, the facts do not show that Taxpayer and Y in good faith and acting with a business purpose intended to join together in the conduct of Business with D. First, there does not appear to be a business purpose for the partnership. Second, Y's interest in the partnership is nominal, and most of its capital contribution was returned to it by means of the special distribution. Third, Y does not participate in the management and control of the business. Fourth, the existence of a tax avoidance motive on the part of Y tends to indicate that there was no bona fide intent to carry on business as a partnership. Commissioner v. Culbertson, supra, 337 U.S. at 744, n. 13. Finally, Y does not provide services to the alleged partnership. If Y were to leave this alleged partnership, there probably would be no detrimental effect on its Business. It is not accurate to state that Taxpayer and D joined together their money, assets or skill for the purpose of carrying on a trade, profession, or business with a community of interest in the profits and losses. See, e.g., Commissioner v. Tower, 327 U.S. 280, 286 (1946); ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 513 (D. C. Cir. 2000), affg. T.C. Memo. 1998-305; and Andantech LLC, et al. v. Commissioner, T.C. Memo. 2002-97. Accordingly, Z should not be treated as a partnership, and Taxpayer should be treated as transferring Assets to D in a taxable transaction.

Finally, although it appears that Z is operating a legitimate Business enterprise, that fact has no bearing on the legitimacy of the partnership per se. For example, in Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989), aff'g T.C. Memo. 1988-72, the court found that a partnership formed to operate an oil rig lacked economic substance, although the operation of the oil rig itself was not a sham, in that the partnership was formed for no other purpose than the creation of tax benefits for its partners.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

By: ______________________________

DAVID R. HAGLUND
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